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DIRECTORATE OF
INTELLIGENCE

# Intelligence Memorandum

## *Chile's Economic Vulnerabilities*



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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1971

INTELLIGENCE MEMORANDUM

## Chile's Economic Vulnerabilities

### Introduction

Allende's program to nationalize US properties in Chile may be setting the stage for a serious confrontation. The US government has insured several properties against uncompensated nationalization and stands to lose as much as $300 million if Chile refuses compensation. US legislation calls for an aid cutoff in the event of uncompensated expropriations of US business interests. This memorandum discusses the outlook for the Chilean economy, its vulnerabilities, and the likely impact of US economic sanctions that might be considered.

### Recent Economic Trends

1. Chile's economy has performed poorly in recent years despite record copper prices averaging more than twice those in the early 1960s. During the last three years there was also a massive $560 million inflow of capital to expand the copper industry, and foreign aid inflows of about $100 million annually. Even so, the average rate of economic growth in real terms fell from 6% annually during 1965-66 to less than 3% during 1967-70. Per capita income has stagnated since 1966, while inflation increased from a low of 17% in 1966 to almost 40% in 1970. Investment outside the copper industry has fallen since 1967 and, except for

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*Note: This memorandum was prepared by the Office of Economic Research and coordinated within CIA.*

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projects receiving government funds, private business actually has been disinvesting.

2. Although the data are incomplete, it seems likely that gross domestic product (GDP) fell in 1970 despite increased copper output and agriculture's partial recovery from drought. Private investment was especially depressed because of the uncertainties surrounding the election, and industrial output fell sharply following Allende's victory in September. Domestic trade was also severely disrupted during the year's final months. Because of these factors, we estimate that per capita income dropped appreciably last year and probably was not much higher than in 1964, when the Frei administration began.

3. Chile has traveled a long way down the road to socialism in recent years. The state's economic role, already large when Frei took office, was greatly expanded during 1965-70. Increased taxes, a wage-price policy that furthered income redistribution, and increasingly vocal attacks on the capitalist system strongly discouraged private enterprise. At the same time, an ambitious agrarian reform, although falling short of its goals, radically changed land tenure in some provinces and attitudes toward private property rights. These programs awakened more desires than could be satisfied -- especially after economic performance generally began to deteriorate -- thus setting the stage for Allende's more radical programs.

## Allende's Inheritance and Initial Measures

4. Allende did inherit some substantial assets, however. The copper expansion program begun in 1967 now is nearly complete and will about double capacity. Foreign exchange reserves accumulated as a result of extremely high copper prices during most of 1969-70 amount to about $400 million. And, lastly, the foreign loan pipeline contains more than $400 million in authorized but unutilized credits.

5. Allende appears determined to spend this inheritance, if necessary, to further his economic

programs and consolidate political control, and thus "make the revolution irreversible." To enhance his popularity, Allende has adopted wage, price, and budgetary policies which will substantially boost real incomes for most Chileans during 1971. Since his inauguration in November, money wages have been increased by 45%, and prices (which traditionally have risen rapidly after wage adjustments) have been frozen. The imminent take-over of the banking system will weaken political opposition by giving the Allende administration effective control over most businesses. At the same time, accelerated radical agrarian reform and government toleration of peasant land seizure are beginning to destroy the economic base of one of Chile's most important conservative groups -- the medium- and large-size farmers in the southern provinces, especially in Cautin, where former President Alessandri won a majority in the September election.

## Chile's Short-Term Prospects

6. Chile's economic prospects for the next year or so were unfavorable before Allende's election and have since worsened. Current policies will generate increasing managerial problems and shortages and prevent economic growth for some time. However, a severe economic downturn is not likely. The urban unemployment rate did grow from 6% in September 1970 to 8% in December, but Allende's wage and price policy should help to sustain output, sales, and employment because decades of inflation have conditioned Chileans to spend their incomes rapidly. Moreover, if increased as planned, public investment would largely offset the loss of private domestic and foreign investment, which accounted for less than 30% of total investment during 1967-70.

7. The prospective sharp increase in consumer expenditures threatens shortages of foodstuffs, intermediate products, and manufactured consumer goods in the months ahead. Because private investment in manufacturing has been extremely depressed for the past four years, we doubt that output can be expanded to meet demand -- especially since private production incentives have been largely

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eliminated. Supply problems will be aggravated if, as we expect, the radical agrarian reform continues apace. Wheat output may increase this year, partly because much of the crop was planted before Allende's election, but private farmers -- who still supply most of Chile's foodstuffs -- have since sharply cut back their plantings of other crops and have begun to slaughter breeding stock. Since Allende will likely try to avoid rationing or other unpopular steps, he probably will try to minimize shortages by boosting imports.

8. Increased imports, possibly compounded by failing farm output, could force Chile to begin spending its foreign exchange reserves. Export earnings this year could fall by $200 million because of reduced copper prices, and capital inflows also are likely to decrease sharply. However, because capital goods imports will also decline and profit remittances of about $70 million to the copper companies will probably be eliminated, Chile is unlikely to suffer a severe balance-of-payments deficit. The balance of payments may well deteriorate during the next few years, however, especially if copper prices remain low.

## Economic Vulnerabilities

9. While the economy faces many problems in coming months, it will not thereby become particularly vulnerable to economic sanctions. Investment is already largely concentrated in government hands, and the complete loss of US investment capital would not have a major immediate impact, especially since the copper expansion program is close to the end. Moreover, it would almost certainly be extremely difficult to enlist West European or Japanese support for any trading sanctions against Chile because these nations have gone on trading with Castro despite OAS-made sanctions and because Chile meets a major portion of their copper needs. For his part, Allende has apparently agreed not to take action against their interests in Chile. In any case, sanctions would boost Allende's popularity and provide an excuse to tighten political control and take desired but unpopular economic actions.

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10. A US embargo of Chilean goods by itself would not have much impact. The United States purchased only 17% of Chile's exports in 1969, compared with 22% in 1968, and with demand for imported copper down in 1970, the US share of Chilean exports probably dropped further (see Table 1). Copper, which makes up most of US purchases from Chile, could be diverted at least in part to other markets (see Table 2). Other exports to the United States -- fresh fruits and vegetables, iron ore, nitrates, fishmeal, wine, and various other small items -- approximate only $40 million a year, and about half of these could be sold elsewhere. The remaining half, consisting largely of animal products and fresh fruits and vegetables and making up about 2% of Chile's exports, would be more difficult to sell. However, such items may not be available for export, because of disruptions from agrarian reform.

Table 1

Chile: Direction of Trade
1969

| | Percent of Total | |
|---|---|---|
| | Exports | Imports |
| United States | 16.9 | 38.5 |
| European Economic Community | 27.3 | 19.3 |
| United Kingdom | 14.3 | 5.3 |
| Other Western Europe | 6.9 | 6.4 |
| Japan | 13.4 | 2.0 |
| Latin America | 10.6 | 25.4 |
| Other | 10.6 | 3.1 |

11. A US prohibition against imports of products containing Chilean copper, similar to the action taken against Cuban nickel, undoubtedly would be more harmful to Chile than direct trade sanctions. However, such a policy would be costly to enforce and would create problems with US trading partners. In any case, this policy has not proved particularly effective in blocking

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Table 2

Chile: Copper Exports, by Destination

| | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 [a] |
|---|---|---|---|---|---|---|---|
| | | | | | | | Percent of Total |
| European Economic Community | 28.2 | 34.9 | 38.0 | 41.3 | 34.5 | 40.4 | 48.5 |
| Of which: | | | | | | | |
| West Germany | 12.5 | 15.7 | 22.7 | 21.2 | 19.6 | 20.8 | 27.0 |
| France | 3.2 | 3.4 | 6.1 | 6.3 | 5.4 | 7.7 | 7.5 |
| Italy | 3.9 | 4.7 | 6.9 | 8.7 | 7.8 | 9.9 | 9.3 |
| United Kingdom | 16.5 | 15.9 | 17.0 | 16.1 | 17.4 | 17.4 | 14.2 |
| Japan | 1.9 | 2.8 | 4.3 | 6.2 | 8.4 | 9.3 | 8.8 |
| United States | 41.0 | 37.5 | 31.4 | 23.4 | 25.3 | 17.2 | 15.6 |
| Other | 12.4 | 8.9 | 9.3 | 13.0 | 14.4 | 15.7 | 12.9 |
| *Total* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* |

*a. Estimated from data for first nine months.*



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Cuban nickel sales and would be unlikely to prevent Chilean copper exports. At best, it probably would create a situation in which Chilean copper was sold at a small discount from the world price.

12. Chile is not critically dependent on US imports. The United States has been a major supplier of capital goods, intermediate products, and technical expertise -- especially to the copper industry -- but these items are, in most cases, readily available from non-US suppliers. Moreover, experience with Western economic sanctions against both Rhodesia and Cuba -- and before them North Korea, Communist China, the USSR, and Eastern Europe -- has shown that severing traditional sources of supply does not lead to severe economic problems, although costs may be increased and economic growth slowed. Because a smaller portion of the Chilean capital stock is of US origin than was the case in Cuba, the impact of such measures as spare parts denials would be more limited.

<u>Operating the Copper Industry</u>

13. US mining companies operating in Chile state that Chileans can operate the mines despite the loss of technicians now taking place, although efficiency will fall and output probably will be less than under US management. Although most of the industry's capital equipment and supplies of reagents and other essential items are of US origin, denial of such items would have little immediate impact. The technology used is common to the copper industry, and supplies of reagents, most capital replacements, and mining technicians are available in Western Europe, Japan, South Africa, and Canada as well as in the Soviet Union and Eastern Europe. Moreover, Chile has inventories of spare parts and supplies, in most cases enough for a year or more. Over the longer run, inability to obtain US equipment and supplies would increase industry costs, but Chile would be able to limit the impact by cannibalizing equipment and purchasing replacements outside the United States. Since Chile produces the world's lowest cost copper, moderate cost increases would not make the industry uncompetitive, although they would reduce government copper income.



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## Denying Other Imports

14. Short of mounting a naval blockade and interfering with coastal shipping, Chile would not be vulnerable to a US-imposed cut-off in oil or other critical supplies. About half of Chile's crude oil requirement is produced by the state-owned oil company (ENAP) in the Magallanes region, and three state-owned refineries meet most petroleum product requirements. Chile now imports most of its crude oil deficit from Venezuela, and some refined products are obtained from Curacao and other sources. If Venezuela and Curacao agreed to halt shipments to Chile, crude oil would be available from state-owned oil companies in North Africa or the Middle East, and refined products could be obtained in Western Europe or from Communist countries. Chile also probably could import the necessary amounts of oil from Bolivia, whose crude oil is now largely exported via pipeline through the Chilean port of Arica. Although Bolivian crude oil has a higher gravity than that Chile now uses, it could be processed if necessary. Chile recently imported 140,000 barrels of this crude oil to run refinery tests.

15. A denial of US capital goods and spare parts for the manufacturing and transport industries would inconvenience but not appreciably harm the economy. Similar goods would be available from both Western Europe and Japan. In contrast to Cuba, where most transport equipment was US-made, Chile has much equipment of West European manufacture. The only serious limitation on Cuba's imports from Western Europe has been a severe hard currency shortage -- a limitation Allende will not face.

16. Chile is highly dependent on imports for foodstuffs and agricultural raw materials, but the United States is not a major supplier of either. Imports of about $175 million in 1970 supplied 20% of Chile's foodstuffs. These imports consist mostly of cereals, sugar, and meat. With demand likely to increase sharply because of increased real wages and population and with farm output likely to stagnate at best, agricultural

imports will have to rise sharply if rationing is to be avoided. Imports of agricultural raw materials amount to another $25 million and also will probably have to be increased.

17. Because higher real wages for Chile's lower classes are quickly translated into demand for food, foodstuff requirements could increase by 20% or so in 1971/72. This probably would mean a doubling of food imports, if major shortages are to be avoided. Increased demand will be greatest for quality foods -- milk, poultry, eggs, meat, and fruit. Because the livestock industry is being particularly hard-hit by agrarian reform, the need to import or ration animal products will be felt quickly. With the ending of the current slaughter of breeding stock (which comes on top of the drought losses of 1969-70), the beef shortage could be severe. Milk reportedly is already in short supply as a result of these factors. Aside from relatively minor PL-480 shipments and some commercial wheat sales, the United States has not been a major foodstuff supplier for Chile. Most meat imports are from Argentina, and Chile has been expanding imports of cereals and dairy products from New Zealand, Australia, and France. Chile recently concluded agreements with Cuba to exchange temperate zone agricultural products and wine for sugar.

## Monetary Sanctions

18. Chile is not particularly vulnerable to a cessation of US government aid. According to several estimates, Chile has a backlog of more than $400 million in long-term credits usable over the next three years; these are mostly West European suppliers credits, Soviet loans, and loans from international organizations. Receipt of some of these funds requires Chile to maintain interest and amortization payments on its external debt which average almost $300 million annually during 1971-73. For example, in the event of an uncompensated expropriation, new loans from the World Bank would halt because of established policy. Only about $70 million of the total backlog consists of US official loans (see Table 3). US sanctions would unquestionably

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give Chile an excuse to default on its $900 million debt to the United States. Because interest and amortization payments due the United States in 1971 will total $65-$70 million -- against only about $30-$50 million in new disbursements scheduled under all existing programs -- Chile clearly would not be the loser. In following years, scheduled US disbursements fall sharply, while Chile's repayment obligations increase.

Table 3

Chile: Unused Development Credits
End of 1970

| | Million US $ |
|---|---|
| United States (AID development loans) | 24 |
| Export-Import Bank | 48 |
| World Bank | 52 |
| Inter-American Development Bank | 99 |
| Belgium (for expansion of state mining enterprise) | 46 |
| France (for Santiago subway) | 52 |
| USSR (extended in 1967) | 55 |
| Estimated other | 24-124 |
| *Total* | *400-500* |

19. Prior to Allende's election, US commercial banks and other financial institutions provided about $250 million in short-term credits. This total has already been reduced by about $50 million and, because of the dismal outlook for private enterprise in Chile, many banks are attempting to reduce their exposure still further. Chile probably will be able to substitute West European trade credits for declining US trade credits -- especially if its import pattern changes -- but we doubt that it will be able to replace US loans to Chilean banks and corporations. However, Chile wants to maintain financial respectability and probably would countinue to pay these

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obligations for at least a year or so even if this meant drawing upon reserves. Interest on these private US credits currently runs about \$15-\$20 million per year. The balance is being reduced as rapidly as possible, however, and the total outflow could reach as much as \$50-\$100 million during 1971. Official sanctions would give Chile an acceptable excuse for blocking this outflow.

## Other Countries' Economic Reactions

20. US sanctions would offer Chile's other trading partners a significant commercial opportunity. The British and French already have shown their eagerness to expand exports to Chile. Japan depends heavily on the US market and might not aggressively pursue trade outlets in Chile for fear of offending the United States. However, the Japanese are the largest non-Communist buyer of Cuba's sugar and probably would not refuse to purchase increased amounts of Chilean copper and iron or supply Chile with capital goods. US sanctions would also give the USSR a better opportunity to expand commercial and military ties with Chile. Chile would have strong motives to make prompt use of the Soviet economic credit already extended and to seek others. Sanctions also might rapidly lead to Soviet military sales to Chile.

## Conclusions

21. The Chilean economy has fared poorly in recent years, and little or no growth is in prospect for 1971. A severe economic downturn this year is not likely, but expropriations, business failures, and stepped-up land reform will doubtless cause some interruptions in output. Allende apparently has adopted a policy of spending to achieve immediate popular support and consolidate his control. Workers' real incomes will rise sharply, and Chile will probably substantially increase its imports of foodstuffs, consumer goods, and raw materials. Although exports will fall in 1971, capital goods imports and profit

remittances will also drop sharply and Chile probably will not severely deplete its foreign exchange reserves.

22. US economic leverage is small in Chile, and economic sanctions would probably be of limited impact on Chile's economy over the next year or two. The United States took only 17% of Chile's exports in 1969 (and probably less in 1970), and most of these could be sold in other markets. The United States has been a major supplier of capital goods to Chile, but blocking future sales would have only a small short-term impact because Chile would be able to purchase similar goods from Western Europe and Japan. Sanctions would probably improve Chile's financial position in the short run because they would give Allende an excuse to default on US public and private loans. Disbursements on these loans at most will probably run only \$30-\$50 million in 1971, while scheduled repayments, interest, and called loans probably will exceed \$100 million.

23. In sum, traditional economic sanctions such as those used against Cuba probably would have little immediate adverse impact on Chile. Indeed they could be counter-productive. Sanctions would give Allende an excuse to tighten his political control, boost his popularity locally, and increase sympathy for his regime internationally as well as cause Chile to move more rapidly to strengthen its ties with the Soviet Union and Eastern Europe.